Stewart Financial

Thoughts that count

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Sugar boost

In the 3rd century, while navigating between trading posts, boat-travelling merchants needed something to improve the taste of the awful food they had available. With limited resources, they created a fermented paste from fish parts and soybeans. They called this new recipe 'koe-chep', which in the local dialect meant 'fish sauce'. Hundreds of years later, a Philadelphian scientist replaced the fish parts with tomatoes and vinegar, and the modern version of ketchup was born.

Among eaters with limited taste preferences, ketchup serves a specific purpose; it makes unsweetened food taste better. Picky eaters across the globe cover their food in this red sugary sauce, so they can tolerate the flavour of the food underneath. Many parents use ketchup as a tool of persuasion to get their children to eat anything remotely healthy. This coverup is extremely effective. Heinz, which overwhelmingly dominates the ketchup market, sells more than 650 million bottles every year. That covers a lot of vegetables.

Since the beginning of civilization, those charged with keeping harmony within their communities (aka the government) have been inventing ways to keep economies moving along in an orderly fashion. Around 110 years ago, Americans created the *US Federal Reserve* to promote this stability goal. Twenty years later, Canada established a similar institution, the *Bank of Canada*, which has the same general objective; to keep the economy stable. These 'central banks' maintain this stability using several levers: most noticeably by setting interest rates. Rates are raised or lowered to nudge individuals towards actions that promote balance:

- When the economy runs too hot, interest rates are **raised**, which increases borrowing costs and incentivizes saving, which slows consumers down.
- When the economy is sluggish, interest rates are **lowered**, which promotes borrowing and disincentivizes saving, which increases consumer spending.

Our world has never been in as much debt as it is now. Individuals, businesses, and governments have gorged on debt over the past few decades. Because debt incurs interest expenses, costs to operate our everyday lives/run our companies/produce government programs have increased. This has damaged economic stability. To counteract this damage, central banks around the world made unprecedented efforts to depress interest rates, cutting them to near zero and leaving them there for 13 years. They did this because low interest rates are the ketchup of economic policy.

Just as slathering on ketchup allows you to eat more vegetables, lowering interest rates masks the otherwise distasteful effects of incurring borrowing costs. Individuals/businesses/governments have a natural aversion to interest expenses, but when interest rates are temporarily eliminated, like ketchup on broccoli, the pain of borrowing is ignored.

Ketchup contains twice the amount of sugar as is found in Coca-Cola. Used sparingly, this is not a problem, but overindulgence in sugar causes a myriad of health problems. The same principle is true of lowered interest rates; a little to help stabilize economic weakness is fine. Overindulgence can create permanent imbalance.

Among the most damaging effects of depressing interest rates for extended periods is the hidden behavioral crutch imposed. As an example, let's say interest rates are 5% and Fred is thinking of buying a $100,000 fishing boat. Unfortunately, Fred doesn't have this cash lying around, but he wants the boat now. So, he has two options; a) he can borrow the money or b) withdraw from his savings. Because he will not be using cash on hand, Fred will be forced to choose between 'opportunity costs'. That is, if he borrows money at 5%, he will have to make interest and principal payments. If he sells investments to generate enough to pay for his boat, he must forgo the return produced by his portfolio;

- If Fred borrows the money at 5% and pays it off over 10 years, he will incur total costs of $127,278 (the original $100,000 plus 10 years of interest).
- If his investments grow at 6% and he cashes in $100,000, he will forgo $79,085 of compound interest over 10 years.

- So, the $100,000 boat is going to cost Fred the original $100,000 plus somewhere between $27,278 and $79,085 of 'opportunity cost' depending on how he chooses to fund his hobby.
- The additional cost of borrowing money or forgone interest acts as a sober second thought for Fred about whether he should buy the boat now, wait or at all.

Now if interest rates were eliminated, Fred's situation would be dramatically different. At 0%, The loan wouldn't appear to cost anything, nor would he have to give up investment income. The effect of lowered interest rates has nudged Fred towards buying the boat now, because the alternative use of cash has been cheapened. The consequences of interest have been covered in ketchup.

Now imagine Fred's situation multiplied by hundreds of millions of consumers around the world, covering wide-ranging transactions, for many years. The reduction (or outright elimination) of opportunity costs gives a massive boost to economic output because people have been tempted to spend in ways they wouldn't otherwise. In the short run, this might be positive. But as people get accustomed to operating in a no-consequence world, they develop bad habits.

Rates have been generationally depressed by central banks since 2009. In 2022, rates began rising as inflation escalated (another result of zero interest rate policy). After 18 months of rising rates, during the 4th quarter of 2023, the market began to anticipate central banks would get out their bottles of ketchup again. As a result, stock and bond markets rallied. The million-dollar question now is how much ketchup are central banks willing to deploy?

Learned financial behaviours are sticky, they take a long time to adjust. We are moving to a period where long-term opportunity costs matter again. Individuals/businesses/governments need to accept a reality where interest costs bite. Investment strategies that rely on an absence of rate costs will struggle and companies that have cost advantages over their competition will prosper.

While interest rates will likely move somewhat lower this year, it is doubtful they will reach the depths from which we just came. The market may not be ready for this reality. Industrial wages are growing, and globalization is slowing, which are both inflationary. This limits the pace interest rates can decline. Making a large bet on the ultimate magnitude of interest rate changes is not prudent. However, investors should ensure their portfolios have flexibility to adjust as central bank policy unfolds. This is how Stewart Financial client's portfolios are positioned; we are prepared for interest rates to remain higher than in the recent past, with embedded flexibility should rates decline. This means we continue to hold short-term bonds with yields in the middle single digits and stock investments in profitable companies with important competitive advantages. There is likely to be far less ketchup for investors this time around.

Your *making the case that hot sauce is the best condiment* portfolio manager,

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